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AND HOW MUCH DO YOU EARN?

Public pressure for government regulation of pay

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the Paragon initiative

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The Paragon Initiative

This publication is based on research that forms part of the Paragon Initiative.

This five-year project will provide a fundamental reassessment of what government should – and should not – do. It will put every area of government activity under the microscope and analyse the failure of current policies.

The project will put forward clear and considered solutions to the UK's problems. It will also identify the areas of government activity that can be put back into the hands of individuals, families, civil society, local government, charities and markets.

The Paragon Initiative will create a blueprint for a better, freer Britain – and provide a clear vision of a new relationship between the state and society.

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Summary

- Economics teaches that freely determined pay arrangements are likely to lead to optimal output and employment, with benefits to both employers and employees. Nevertheless politicians are increasingly under pressure to intervene in the determination of pay.
- Low pay is not synonymous with poverty, but politicians argue that higher minimum wages can help to relieve poverty without cost to the taxpayer.
- Minimum wages do not always work in a simple manner, but ultimately there is a trade-off between higher pay rates and employment, particularly if the level of the minimum wage is increased substantially. The recent introduction of the National Living Wage has politicised low pay in a potentially damaging way.
- The existence of a ‘pay gap’ between groups of workers is not necessarily a sign of discrimination. The government’s planned publication of ‘league tables’ could have undesirable side-effects on women who are supposed to benefit.
- High pay for company executives is only one manifestation of the market for talent; others include high pay for sportsmen and entertainers. Government changes in company structure and regulations on pay-setting are unlikely to resolve the issue, but could create difficulties for the UK if multinational businesses decide to delist.
- The government needs to be wary of continually making concessions to single-issue pressure groups; in the nature of things there is no organised opposition to continual intervention over pay.
- Minimum wages should be simplified, the Low Pay Commission should have its authority restored, and Scotland should be able to set its own minimum wage rates.

- A better approach for the government to try to address poverty would be to review policies which raise the prices of food, energy and housing for the poor.
- The government should abandon planned publication of gender pay gap league tables and encourage a more sophisticated analysis of pay differences between a range of different groups.
- If high pay is felt to be a problem, it should be dealt with through simplifying the tax system and eliminating loopholes. This would affect all very high earners, and not just those who take on the responsibilities of running our great businesses.

Introduction

Politicians find other people's pay endlessly irritating. The Soviet Union attempted to impose pay structures which conformed to political priorities, placing reliance on a reading of Marx's version of the labour theory of value. This meant, for example, higher pay for 'productive' workers, who made things, than for service workers involved in what Marx called 'the distribution of surplus value'. Predictable consequences included shortages of labour in some areas (secretaries in Moscow, for example) and excess supplies elsewhere. This in turn led to direction of labour and restrictions on the internal mobility of workers.

In the UK, pay regulation has always been less extreme. We did, however, experiment in the 1960s and 1970s with attempts to control wage inflation through incomes policies. These policies aimed to restrict average pay increases to the rate of growth of labour productivity (always a slippery concept, like most aggregated variables). Many groups of workers claimed to be exceptional cases, demanding that their pay should rise faster than the 'norm'; unsurprisingly, few if any thought they deserved less. Where workers had union muscle behind them, they often won larger increases.

Incomes policies were unsuccessful because inflation was caused by monetary expansion. But the experience also shows just how easily government diktats on pay (even backed by sanctions) can be undermined by private initiatives beyond our rulers' control. As one author put it, 'all that was required to evade the policy was an exercise in ingenuity' (Richardson 1991: 440).

Most of today's politicians were wearing nappies when government powers over wages were shown to resemble the Emperor's New Clothes. But they should reflect that the 'ingenuity' shown by previous generations of employers and employees is still present today. We no longer attempt to control average pay, but our rulers are again becoming obsessed with wage-setting, albeit for different reasons.

This appears to be largely down to shifting public attitudes. In the past it would have been considered rude to ask or write about how much an individual earns. But the new normal is for everyone to have an opinion on how much everyone else should be paid. Such disparate commentators as *The Guardian*'s Polly Toynbee and Conservative MEP Daniel Hannan have called for all our income tax returns to be publicly available. This nosiness feeds into debates surrounding minimum wage policies, income inequality and various earning 'gaps' between groups of employees.

Pay is becoming increasingly politicised, and not just in terms of those things politicians currently control (whether it be public sector pay or minimum wage rates). Politicians pass instant judgement, often moralising in the process, on everything from how restaurant tips are handled to how much 'top talent' at the BBC is paid. As the recent adoption of the National Living Wage has shown, these off-the-cuff pronouncements can sometimes be leading indicators for future legislation.

In this paper we assess the politicisation of pay in three different areas which are now mainstays of political debate: minimum and 'living' wages, the gender pay gap, and high pay. For each we explain how politicisation has impacted policy, examining the economics behind claims that 'something must be done' and the likely effects of interventions. Using theory and evidence, we conclude by setting out what the government's role should be (if any) in pay determination.

Minimum wages

Contracts formed in free and competitive labour markets offer ‘gains from trade’ for both parties. Employers gain output to be sold at a profit while workers gain income to purchase goods and services they want or need.

Employers will want to employ labour up to the point where the value of incremental output is just equal to the cost of an extra unit of labour. Employees want to work up to the point where the return from an extra hour’s effort is just equal to the value they place on alternative uses of time such as work in the home, study or leisure. Each party to the bargain is better off than they would be otherwise.

In the simplest case, market forces cause adjustments in pay when supply and demand are out of balance: a shortage of labour drives up the wage rate, while an excess supply brings it down. Mainstream economics teaches that this leads to optimal levels of output and employment and allows the economy to respond quickly to change. Conversely, interference with market forces may lower output and employment and slow longer-term economic growth.

But many politicians and voters think otherwise, in particular believing that low pay is a social evil requiring government intervention.

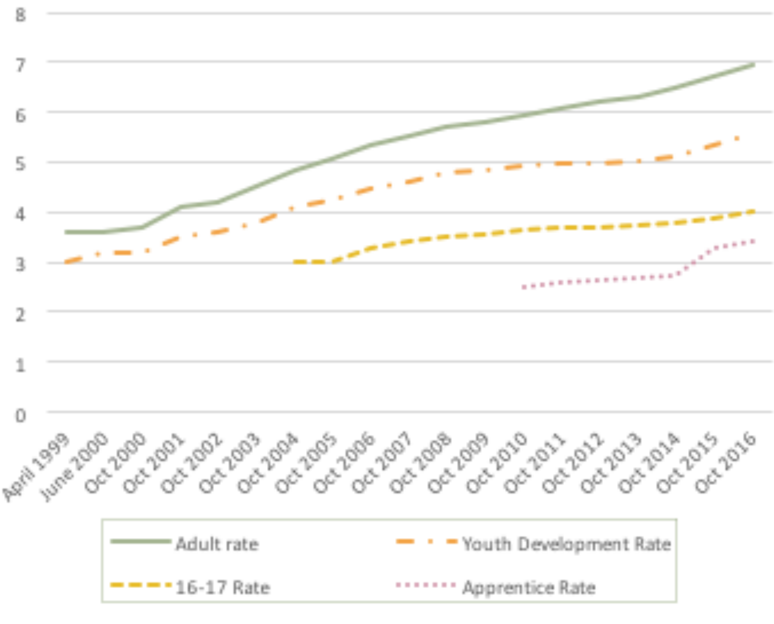
The National Minimum Wage and the National Living Wage

The UK’s National Minimum Wage (NMW) – an hourly wage floor – was introduced by Tony Blair’s New Labour. It was a transformative policy shift.

Although minimum wages had been set in specific low-paid trades[1] from the first decade of the 20th century until the early 1990s, there had never been a national minimum – historically anathema to the trade union movement, which preferred pay to be determined by collective bargaining.

Though initially opposed by the Conservatives, the NMW is now accepted by all political parties. An independent Low Pay Commission (LPC) was created to set it, with representation for trade unions and employers, together with a strong academic component. This body now advises the government on different NMW rates for adults, 18-20 year-olds (the 'development rate'), 16-17 year olds; and for apprentices under 19. The rates are usually proposed early in the year, for operation from the following October. Figure 1 shows how they have evolved over time.

Figure 1: The National Minimum Wage (£ per hour) over time



Source: Low Pay Commission

1 Trade Boards were set up under President of the Board of Trade Winston Churchill in 1909 to fix minimum wages in four 'sweated trades' where unions had little power. They were expanded between the wars to cover a wider range of manufacturing and services, and renamed Wages Councils in 1945. They were abolished, with minor exceptions, in 1993.

The terms of reference for the LPC required it to recommend levels for minimum wage rates 'that will help as many low-paid workers as possible without any significant adverse impact on employment or the economy'.[2] This is important, as it flags up explicit concerns with employment and not just with living standards. The Commission's recommendations, based firmly on evidence about demand and supply conditions in the labour market, have therefore been fairly conservative. They have usually been accepted by successive administrations.

As Figure 1 shows, the 'adult'[3] minimum wage has risen more or less continuously in money terms, although some of the other rates have increased only fitfully. The under-25 adult rate now (June 2016) stands at £6.70 an hour, and will rise to £6.95 in October. Despite fluctuations over the period (after 2007 it fell back in real terms, but has since recovered) the NMW has also increased in value over time. Between 1999 and 2016 the adult rate grew by over a third in real terms.[4] It has also increased significantly as a proportion (its 'bite') of median hourly earnings. Moreover this has been achieved against a background of rising employment, only temporarily halted during the post-2008 recession.

This apparent success has emboldened those who wish to see pay rise faster, notably the Living Wage Campaign, spearheaded by the Living Wage Foundation (LWF). The LWF has called for a much higher level of minimum pay based on an assessment of acceptable living standards (see box). It encourages employers to sign up to paying its target Living Wage: those doing so are accredited and can display the Foundation's logo on their premises and in their marketing.

2 https://www.gov.uk/government/organisations/low-pay-commission/about/terms-of-reference (accessed 28 June 2016)
3 Although the age of adulthood changed slightly, all adults were paid the same NMW until April 2016 when the National Living Wage came into force for over-25s.
4 Calculated using the Consumer Price Index measure of inflation: in RPI terms real growth was slower.

The Living Wage Foundation

The Living Wage Foundation, a coalition of church leaders, trade unionists, poverty campaigners and sympathetic businesspeople, encourages employers to pay an hourly wage calculated to give a full-time worker an income sufficient to reach a decent standard of living.

At the beginning of 2016, while the NMW stood at £6.70 per hour, the Living Wage Campaign was advocating a rate of £9.40 an hour in London and £8.25 an hour outside the capital. The figures are updated annually.

The Living Wage targets are calculated by two different bodies. In London, GLA Economics, a body under the auspices of the London Mayor, sets the figure. The outside-London target is produced by the Centre for Research in Social Policy at Loughborough University. These bodies, using both expert opinion and focus groups, set a figure (based on a number of stylised households with different patterns of work and family commitments), which is said to suffice for an adequate level of warmth and shelter, a healthy diet and a reasonable level of social integration. In London, this needs-based approach is complemented with an analysis of those earning less than 60 per cent of median income for each household type. In both cases a weighted average Living Wage is produced reflecting the mix of households in the population.

This figure, unlike the National Minimum Wage, is set without reference to employer ability to pay: It is a purely voluntary target. A number of major private sector employers have signed up to it, proudly proclaiming that they pay all their workers at or above the Living Wage - although few are employers of large numbers of low-paid workers. Some local authorities, particularly those controlled by Labour, have also joined the campaign.

Responding to this mood, the Conservative government returned at the last general election changed the nature of minimum wage setting. George Osborne announced in his July 2015 budget[5] that a new ‘National Living Wage’ of £7.20 an hour for over-25s would be implemented from April 2016; furthermore it was intended that this would rise to over £9 by 2020 – the aim being to hit a target of 60 per cent of median earnings from then onwards. As a result, it is estimated that by 2020 about 3.7 million workers (13.7 per cent of all employees) will have their pay determined by a government-set minimum.

5 One reason why Mr Osborne introduced the NLW was to reduce the budgetary cost of tax credits – wage supplements - paid to low-paid workers.

The effects of minimum wages: theory and evidence

Standard economics suggests that a wage floor set above the market-determined level will mean fewer labour-hours are demanded, while workers will wish to supply more hours. In this framework, the gains to those receiving higher pay have therefore to be weighed against losses of hours or employment opportunities to other individuals.

In practice, even the apparent gainers from higher pay may not gain as much as expected. The returns from jobs are not just reflected in the basic wage rate: they involve things such as the provision of training, working conditions, premium overtime rates, pension schemes, staff discounts and other fringe benefits. Faced with increases in the minimum wage, employers can adjust these rather than cut labour hours. The advent of the National Living Wage, for example, has been marked by a number of stories in the media which illustrate this: firms such as B&Q and Waitrose have been accused of lowering premium pay for weekends and other 'unsocial hours', while Caffe Nero staff seem to have lost the perk of free paninis – showing that minimum wage increases are no 'free lunch'. Those gaining from pay increases therefore lose out in other ways than jobs or hours lost.

It is often argued that the 'shock' effect of minimum wages can induce previously lethargic employers to search for ways of increasing labour productivity, allowing them to maintain or even increase employment. In such circumstances there need be no obvious losers from the minimum wage. This is certainly possible if the increased productivity comes from improved organisation and the reduction of what economists call 'X-inefficiency' (Leibenstein 1966), or perhaps because of investment in training.[6] But the evidence is thin. Productivity gains that individual firm case studies of increased wages often highlight relate to employers being able to attract and choose from keener or more conscientious employees. These gains clearly cannot be replicated on an economy-wide basis if all workers, conscientious or not, are paid extra.

Furthermore, if productivity increases come from a switch to investment in labour-saving technology, such as self-check-outs in supermarkets, the longer-run impact of the minimum wage might be to generate larger

6 X-inefficiency is the difference between efficient behavior of businesses assumed or implied by economic theory and their observed behavior in practice caused by a lack of competitive pressure.

reductions in employment, particularly low-skilled employment, than is the case in the short run.

Sir John Hicks (1932) long ago pointed out that the standard model in effect assumes perfect competition in the labour market. If, however, there is monopsony – a single buyer of labour in the market - government imposition of a modest minimum wage can theoretically lead both to an increase in pay per hour *and* an increase in hours of employment (Bourne and Shackleton 2014). In these circumstances workers seem to gain unequivocally from the minimum wage.

Yet unambiguous examples of monopsony – such as the 'company town' – are vanishingly rare in the modern world. In fact, most low-paid sectors, such as hospitality and catering[7], are surely highly competitive when we look at such conventional indicators as numbers of competing employers and freedom to enter or leave the industry. Some economists, notably Alan Manning (2003), claim that all employment situations have some element of monopsony: employees have imperfect information and this, coupled with the costs of switching jobs, always gives the current employer a degree of market power over workers. This explanation ignores that it is costly for the employer to dismiss existing employees and recruit replacements (Kuhn 2004).

Theory, then, doesn't seem to get us very far. Does empirical evidence shed any light? Two decades ago David Card and Alan Krueger (1994) startled economists with their findings on the effect of minimum wage increases in New Jersey restaurants. They claimed that wage hikes did not in practice cause reductions in employment: indeed they may actually have been associated with employment increases relative to a neighbouring state where no such pay increase occurred.

Later analysis (Neumark and Wascher 1995) using payroll data instead of Card and Krueger's telephone survey, found a conflicting result: the minimum wage increase, it turned out, *had* reduced employment after all. Battle over these and many other studies has raged ever since. Nevertheless a broad consensus view of the academic literature seems to have emerged. This is that minimum wage laws have a small but significant negative effect on overall employment levels, with the effect being greater for young adults (Williams and Mills 2001; Neumark and Wascher 2004) and in

7 The adult minimum wage in accommodation and food services is over 80 per cent of median hourly earnings.

recessions (Dolton and Rosazza Bondibene 2012).

These early studies took an essentially static comparison before and soon after a minimum wage change. Economists now stress the *dynamics* of the labour market (Meer and West 2013): even if the labour market is in some sort of 'equilibrium', firms will always be simultaneously gaining and losing workers as people move in and out of jobs for a variety of reasons. Since there are costs associated with firing workers – redundancy payments, loss of expertise from the firm and psychological costs to managers who dislike unpleasant scenes - the reaction to an introduction of or increase in the minimum wage might therefore be a gradual reduction in hiring, rather than sacking existing workers. Indeed, work using Canadian data (Brochu and Green 2013) suggests that in some cases firing rates may fall when minimum wages rise, as cuts in hiring take the strain when it comes to employment reductions.

The effect of this on the actual level of employment may therefore come about through natural wastage as workers leave voluntarily (Neumark and Wascher 2007). This is supported by the work of Aaronson, French and Sorkin (2016) on the US restaurant industry. Their approach demonstrates that, though existing firms may not reduce employment by much when wages rise, as firms leave the industry, new entrants which replace them employ less labour.

Time lags[8] make it difficult to measure directly the consequences of introducing, or changing the level of a minimum wage, since they can be masked by shifts in demand (positive or negative) for goods and services produced by low-paid labour.

And remember that, in the sort of low-paid job where the minimum wage is paid, hours worked may fall rather than employment (Stewart and Swaffield 2008). This is confirmed by HM Treasury analysis which showed that since 2007, the growth of weekly wages for NMW wage workers had tended to be below the growth in the hourly rate (BIS 2014). There is some evidence that hours worked by young people fell as a result of minimum wage increases during the recession (Bryan, Salvatori and Taylor 2012).

8 The studies by Aaronson et al. suggest that, while the short-run elasticity of demand for minimum-wage labour is only 0.1, it is 0.4 in the long run. This latter elasticity is used by the Office of Budget Responsibility (OBR 2015: 204-6), in its modelling of the NLW.

Policy

This all suggests that introducing or raising a modest minimum wage may not produce detectable reductions in employment in the short run. But this does not mean that large increases in wage levels can be engineered without eventual reductions in jobs, hours worked or a combination of the two. *The level of the minimum wage still matters*. Minimum wage increases are always potentially a trade-off, between raising pay for those fortunate enough to keep their jobs and hours against the potential reduction in labour demand. Any significant reduction in demand will hit young and unskilled workers, particularly those from minority groups, hardest. It is also likely to have a bigger impact in some parts of the country than others. Figure 2 shows that the 'bite' of the National Minimum Wage has been considerably deeper in Northern Ireland and the East Midlands than in London.

Figure 2: Adult minimum wage as % of median hourly earnings by region/nation

April 2015

Source: ONS

The Low Pay Commission has been aware of the jobs-pay trade-off and its remit explicitly called for it to take into account the impact on the labour market. This is not the case with the new National Living Wage, which is likely to have a significant impact on jobs in the medium term, particularly since there will probably be knock-on effects on the pay of other workers as firms attempt to maintain pay differentials. At the time of the announcement of the NLW, the Office of Budget Responsibility expected it to lead, even assuming continued favourable macroeconomic conditions which we cannot count on, to a loss of 60,000 jobs and a reduction of four million hours' work a week by 2020 (OBR 2015: 204).

Apart from increased risks to jobs and hours at projected wage rates, the National Living Wage is already leading to increased politicisation of low pay. The Living Wage Campaign thinks it is only a halfway house and still wants to see its own higher rate widely adopted: Jeremy Corbyn has proposed that big businesses which don't pay this higher rate should not be allowed to pay dividends to shareholders. While this particular threat is probably unworkable, other proposals will surely follow: if millions of people have pay determined directly by the government, their votes are up for auction. It would be unsurprising to see the NLW drift closer over time to the Living Wage Campaign's target figure. If this happens there will surely be substantial job losses, as there would be if there were a move towards extending the higher NLW rate to all workers, and not just the over-25s (another LWF objective).

Linking the NLW to 60 per cent of median earnings from 2020 is supposed to allow some flexibility. If the economy hits a recession or a period of income stagnation, and median earnings are static or falling, the NLW need not rise. But given the precedent for political determination of the wage, it seems unlikely that a Chancellor (unable to pass the buck to the Low Pay Commission) will in future be prepared to announce nominal cuts or freezes to minimum wage rates to what will now be a much larger proportion of workers. Pressure for the National Living Wage came precisely because of cautious minimum wage setting following the financial crisis. A future recession could therefore lead to worse outcomes than expected.

Politicians have also demonised businesses attempting to mitigate the effects of the NLW. George Osborne warned companies of the reputational dangers from cutting staff perks to compensate for the higher cost of the NLW, while former minister Nick Boles promised ‘to use the full force of our office… to put pressure on those companies to live up not only to the legal obligations…but to their moral obligations’.[9]

Previously governments have publicly shamed – probably sometimes unfairly[10] - those failing to pay the NMW. But employers now seem to have acquired additional moral obligations going beyond the law. It is unclear who exactly politicians think should bear the burden of higher minimum pay. Apart from the nebulous idea of increasing productivity (which we have seen is anyway quite likely to lead to job losses), the cost can only be borne by consumers paying more, shareholders getting reduced dividends, or taxpayers paying more for home carers or hospital cleaners. In competitive markets, there is a limit to what can be passed on to the consumer. Lower dividends will in the long run lead to reduced investment or withdrawal from businesses employing large amounts of low-skilled labour. And higher public spending is difficult in a time of retrenchment.

By labelling the new rate as a National ‘Living’ Wage, moreover, the government has entrenched the Living Wage Campaign’s philosophy that businesses should set pay not according to the work you do, your productivity or broad market conditions, but according to your cost of living. It is not clear what moral obligations companies have to compensate workers for rises in rents and fuel bills, which are in many cases driven by government policy decisions (Niemietz 2012).

In all this, it is worth reminding ourselves that a ‘Living Wage’ is a misnomer. Three-fifths of those earning less than the Living Wage Campaign’s targets work part-time: they cannot reach a minimum living standard through wages alone. In many cases, however, this may not matter. A large proportion of low-paid part-time workers are students and other young people who have family and other support.

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9 http://www.bbc.co.uk/news/business-36082247 (Accessed 29 June 2016).

10 The Department for Business, Energy and Industrial Strategy regularly publishes a list of offenders, but many seem to be small businesses which misunderstand the complicated rules on minimum wages relating to, for example, piece rates, registration of apprentices, training costs, travel between appointments, accommodation disregards, withholding of pay etc.

Even full acceptance of the Living Wage Campaign's targets would not be very effective in combating poverty. It obviously could not help the unemployed. The Institute for Fiscal Studies (2014) has further calculated that, of those families in which someone earns less than the LWC's targets, only 6 per cent are in the bottom 10 per cent of the family income distribution. By contrast 44 per cent are in the top half of the income distribution, with 5 per cent in the top decile. Many of the low paid may be, for example, young people living with better-off parents, students who will get better-paid jobs later in their career or part-time employees living with spouses with full-time jobs. Few adult workers who are sole family earners remain for long periods on very low pay levels. Such individuals and their families are a real concern, but they are better supported through improved training opportunities and, where necessary, in-work benefits.

The gender pay gap

Another politicised pay issue concerns the difference between male and female earnings. Despite Equal Pay having been mandated in the UK since the 1970s, women still earn on average significantly less than men, as in most countries. The size of this ‘gender pay gap’ causes considerable controversy, and governments have tried to reduce it. Public sector organisations are required to conduct regular audits of pay in an attempt to narrow the male-female differential, a requirement recently extended to large private sector firms. Meanwhile, employment tribunal judgments have frequently found both public and private sector employers in breach of equal pay law and ended observed pay disparities, awarding compensation which can be backdated for up to six years.

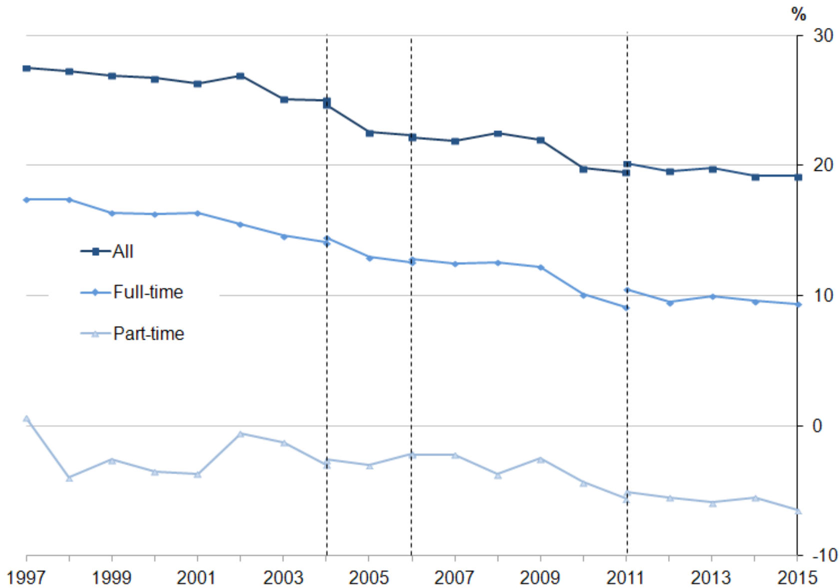
Measuring the pay gap

Figure 3 shows how the pay gap has evolved over time. The preferred measure of the gap from the Office for National Statistics is median gross hourly earnings, excluding overtime, of full-time workers. The median is used in preference to the mean because a small number of very high earners can pull the mean up sharply. Hourly earnings are used because men tend to work longer hours and do more overtime than women. The comparison is between full-time workers as part-timers are paid on a different basis (and typically paid less per hour). Over the period shown, this gap - the difference in male and female pay, expressed as a percentage of male pay - shrank from over 17 per cent to just under 10 per cent.

The Equality and Human Rights Commission prefers another measure – the pay gap between all male workers and all female workers. As a higher proportion of females works part-time, and part-time work is commoner in lower-paid occupations, this gap is larger. It has also fallen over time, from around 28 per cent in 1997 to under 20 per cent in 2015.

The final measure shown in Figure 3 is the part-time pay gap. Its negative value means a pay gap in favour of women: women working part-time tend to earn more than male part-timers. This is because male part-timers, disproportionately young and semi-retired workers, do mainly unskilled jobs in areas such as retailing, while women part-timers are more evenly spread across all age groups and in a range of jobs which include relatively well-paid work such as medicine and teaching. This alerts us to the fact that differences between male and female pay cannot be attributed in any simple way to employer discrimination.

Figure 3: Gender pay gap for median gross hourly earnings (excluding overtime), UK April 1997 to 2015



Source: Office for National Statistics

Note: Changes in the methodology and data source employed mean there are breaks in the series.

Pressure from the Equality and Human Rights Commission and lobbying organisations such as the Fawcett Society has led to concern about this issue being translated into policy. In July 2015 David Cameron pledged to 'end the gender pay gap within a generation'.[11] The new prime minister is known to support this ambition. Plans have been announced to force larger employers to publish information about their bonuses for men and women as part of their gender pay gap reporting. 'League tables' are to be published ranking the size of company pay gaps. There is a clear direction of travel towards much greater government scrutiny of firms' pay policies.

Why are women paid less than men?

Aggregate pay gaps such as those shown in Figure 3 reflect many potential reasons why any group has lower average pay than another (Longhi and Platt 2008). They include differences in education levels and qualifications[12], average age, experience, hours worked, industries and occupations, whether in the public or the private sector (women are more likely than men to be employed in the public sector), and so on.

There are also less obvious factors, such as time spent commuting: this is associated with higher pay, other things being equal, and men travel greater distances to work. Other 'compensating differentials' may be associated with unsocial hours, physical danger[13] and working outside or in isolated conditions. Men are more likely than women to be in jobs with some of these characteristics.

On the other hand, some jobs with attractive features may induce workers to accept lower pay than they could get elsewhere. Women are more likely than men to prefer working in public sector or non-profit organisations, jobs which involve working with people, and jobs with an obvious moral dimension. They are less likely than men to value pay strongly over other features of the job. Many studies also show that women tend to be happier at work than men. Compensating differentials may thus be an

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11 Press release: Prime Minister: My one nation government will close the gender pay gap https://www.gov.uk/government/news/prime-minister-my-one-nation-government-will-close-the-gender-pay-gap (Accessed 29 June 2016).

12 Not just the number of GCSEs, A levels or degrees but the subject matter is important: girls and young women disproportionately choose subjects with a lower market value (Morgan and Carrier 2014).

13 Around 96 per cent of all fatal injuries at work occur to men.

important, too often ignored, explanation of much of the pay gap (Shackleton 2008).

A growing literature, beginning with Niederle and Vesterland (2007),[14] also demonstrates that women are less willing to engage in competitive behaviour than men. Symmetrically, women are more likely to choose cooperative incentives than men (Kuhn and Villeval 2015). This reduces the number of women willing to work in well-paid but highly competitive environments such as financial trading. Similarly, Balcock and Laschever (2003) claim that US women are less willing than men to negotiate over salaries, partly because they have lower salary expectations than men. Similar differences in expectations seem to be the case in Britain.[15]

Finally, and very importantly, it is well known that a key element is family commitments, which alter employment patterns and consequently pay. In the age groups 20-29 and 30-39, women's median earnings in the UK are now higher than men's. This reflects young women's educational achievements, now comfortably outstripping those of young men, plus the later age at which women now have their first child (Olsen et al. 2014). The pay gap really starts to kick in with the advent of children (Leaker 2008). Women drop out of the workforce to have babies. On return they often switch to part-time work or take jobs with fewer responsibilities. These jobs usually involve less pay and fewer prospects for promotion. Less obviously, men with children tend to work longer hours and focus more on their careers than single men; this tends to increase the pay gap from the male side.[16]

Many recognise that the gender pay gap can in part be explained as a 'motherhood gap', but still believe this is a 'problem' that needs to be solved. This seems to rule out the possibility that having children and taking time off to care for them might be a fulfilment of individual or household preferences. Instead, 'social attitudes' are highlighted as being damaging to the prospects of women.

14 Women in their study are more likely than men to choose a non-competitive piece rate rather than take part in a 'tournament' incentive scheme offering potentially higher pay.

15 'Female pupils set pay hopes £7000 lower than boys', *Daily Telegraph,* 30 November 2015.

16 The extension of paternity leave, and the new possibility of sharing parental leave, is partly intended to reduce this effect.

Attitudes aside, there is little evidence attributing gender pay gaps to some unspecified element of discrimination (as is commonly asserted), as they largely reflect patterns of behaviour and priorities which differ on average between men and women. Taking ‘raw’ pay gaps (i.e. without controlling for the various factors determining pay) cannot tell us much about the degree and cause of any disadvantage which women may suffer in particular workplaces. In the public sector, for example, there are huge disparities in the size of the pay gaps in the Ministry of Defence and in Job Centre Plus - similar organisations, of similar size, sharing the official culture of concern over equality issues, together with strong unionisation. It is difficult to believe tightly constrained management behaves very differently in these various parts of the public sector. Rather the variations represent different patterns of employment, different types of skills and a host of other factors largely beyond the control of government. The danger of the planned league tables for private sector employers is that employers with spuriously large gender pay gaps will be wrongly stigmatised for their policies.

Other pay gaps

Politicians’ attention has focused on the gender pay gap; yet there are big variations in pay levels within genders. There are many high-earning women, and many low-earning men, so to concentrate too much on overall male-female differentials is to ignore other dimensions of pay inequality, some of which are at least as significant – and where there is often more evidence of direct discrimination.

It has long been known, for example, that there are distinct variations in pay between different ethnic groups (Metcalf 2009). Most are on average paid less than white British workers, with the exception of people of Indian or Chinese heritage. Male full-time workers of Pakistani heritage earn less than white British women.[17]

People with disabilities do worse than the rest of the working population. Religion is also a factor: in one study (Longhi and Platt 2008) Muslim men had a pay gap of around 17 per cent in relation to Christian men – while Jewish men earned 37 per cent more than Christians. Sexual orientation

17 Incidentally, one side-effect of narrowing the pay gap between men and women might be to intensify other dimensions of inequality. If as a consequence two-earner white couples saw an increase in their joint income it would increase the gap between them and one-earner households, which are commoner amongst those of Pakistani heritage.

(Arabsheibani et al. 2005, Drydakis 2014) is also associated with pay differences, with gay men and lesbians earning more than their heterosexual counterparts. There is also evidence of large pay gaps between people rated attractive and those rated unattractive, tall people and short people, and obese people and those of average weight.[18]

As with gender pay, these other ‘gaps’ need to be deconstructed to make sense. Jewish men, for instance, earn much more than Christians because they are typically better qualified and are in high-paying occupations. Similarly Indians earn more than white British workers because they are disproportionately professionals - doctors, academics, pharmacists, lawyers. Lesbians may tend to cluster in a relatively limited series of jobs, and are more career-oriented on average than heterosexual females (who are more likely to have caring responsibilities).

The point to emphasise is that a pay gap means little in itself without knowing more about the characteristics of the groups concerned: it is a poor guide to policy. Unfortunately, that does not deter politicians, and their responses are often counter-productive. The requirement to report gender pay gaps, mentioned earlier, will spotlight firms with a large pay gap irrespective of the cause of the gap. This will almost certainly lead managements to attempt to manipulate this indicator to avoid being seen as a ‘bad employer’. Paradoxically, this could in some circumstances worsen the position of women. Those firms initially employing large numbers of women on low pay may try to outsource work instead, for example. And some employers may in future be reluctant to take women on unless in high-paying roles.

18 See Harper (2000), Schick and Steckel (2010). There have been proposals to extend anti-discrimination legislation to cover discrimination based on physical attributes.

High pay

Finally, high pay has also become increasingly politicised amid widespread concerns about inequality. While some of this concern is overblown – the Gini coefficient measure of income inequality reached a peak in 1990 and has been declining slowly since – there does seem to have been an increase in the share of income going to very high earners. By which we mean not the top 10 per cent, but the top 1 per cent, perhaps even the top 0.1 per cent (Bourne and Snowdon 2016). This phenomenon, not confined to the UK, has taken place against a background of static or declining pay for many workers since the recession (although the position of the lowest paid may have improved), which explains much of the political context.

CEO Compensation

Most attention has focused on the pay of top business executives. The High Pay Centre - a pressure group of academics, business consultants and journalists – produces regular reports on the subject. In August 2015 it reckoned[19] that FTSE-100 chief executives were being paid on average 183 times as much as the median full-time UK employee, up from 160 times in 2010.

19 http://highpaycentre.org/files/State_of_Pay_Aug_2015.pdf (accessed 29 June 2016).

As long ago as the 1930s, economists drew attention to the divorce between ownership (dispersed shareholders) and control (salaried management) in large corporations (Berle and Means 1932, Marris 1998). This separation may allow management to pursue policies which are not necessarily always in the interests of the shareholders – including over-generous pay for incumbent executives. In modern economics this is seen as an example of a more general principal-agent problem (Jensen and Meckling 1976). Economists have argued that the solution in the case of business firms is to devise a remuneration system tying executive reward to the profits or share price of the company (Jensen and Murphy 1990). The influence of these ideas, particularly in the USA and the UK, has been considerable: hence the growth of pay packages incorporating large performance-linked elements such as bonuses and share options.

Designing performance-related pay schemes is difficult at all levels of an organisation, as individuals will adapt their behaviour to maximise their performance on the criteria which determine their pay and neglect performance in other areas. At the top of a company these difficulties are compounded. When executives are in a position to manipulate information about company performance, they may be tempted to do so.[20] There is now a substantial literature (Conyon 2006) on the factors which determine an appropriate pay structure for executives.

There is evidence that, despite claims to the contrary, FTSE-100 performance usually is reflected to some extent in chief executive pay. Bell and Van Reenen (2012) find that a 10 per cent increase in firm value is associated with an increase of 3 per cent in CEO pay. Perhaps more importantly, declining firm performance is followed by CEO pay cuts and significantly more CEO firings. Of course other factors play a part, as they do in the determination of any pay. The role of chief executive in a large corporation requires skills and experience which few possess; it is also demanding work with long hours and much travel. Individuals have to be resilient and totally focused on the firm.[21] Furthermore, pay has risen over time for many of the same reasons as the pay of entertainers and sportspeople has risen; there is now a global market for top executives, and pay is driven up by competition for the best performers.

20 For instance Tesco seems to have deliberately overstated its profits in the first half of the 2014-15 financial year by demanding promotion payments from suppliers and delaying bill settlements. See http://www.bbc.co.uk/news/business-29735685 (accessed 29 June 2015)

21 See ‘Executives battle burnout in world that’s ‘always on,’’ *The Times,* 30 November 2015.

An incoming CEO can make a big difference to a firm, and the market reflects this. When Tidjane Thiam, the Chief Executive of Prudential, announced in March 2015 that he was moving to Credit Suisse, Prudential's shares fell by 3.1 per cent (a fall in value of £1.3 billion) while Credit Suisse's shares rose by 7.8 per cent (£2 billion). Evidence suggests that the impact of CEOs on share prices has been growing over time.[22] Such highly regarded individuals have to be paid generously if they are to be attracted to a company or retained, just as footballers Cristiano Ronaldo or Gareth Bale are able to command high pay for their services.[23]

Critics of high pay point to cases where executives whose businesses have done badly nevertheless receive generous pay-offs, seeing this as a 'reward for failure'. Perhaps so, but it is probably inevitable in some cases. For one thing, 'failure' in business arises from many different causes: the chief executive may not always be to blame, but nevertheless a change in management can make sense from a shareholder perspective. Payoffs are thus often necessary to prevent damaging litigation by a boss who has been dismissed. The very similar cases of dismissed football managers and coaches are rarely discussed in this context. In 2008 Chelsea spent £23 million paying off the contracts of two managers (Jose Mourinho and Avram Grant) and five coaches.

Despite the negative headlines that surround them, these sorts of 'golden parachute' payments may serve some useful economic functions, such as protection against arbitrary dismissal, providing security to executives seeking to undertake significant reforms of companies and incentivising commitment to a firm.[24]

22 A recent study of 240 sudden and unexpected CEO deaths shows that market reactions to these events in U.S. public firms increased markedly between 1950 and 2009 (Quigley et al., forthcoming).

23 There is, interestingly, no popular demand for controlling the pay of footballers or entertainers, many of whom earn far more than all but a handful of company executives.

24 See http://www.policyexchange.org.uk/images/publications/on%20fairness%20-%20feb%2011.pdf (accessed 25 July 2016).

Reforms

Not all CEOs are superstars, of course. Critics may have a point if less-than-stellar executives have their pay set by remuneration committees which operate without adequate scrutiny and are not genuinely independent from the incumbent management[25]. Concern about this led to the Greenbury Report (1995) which recommended that each board should have a remuneration committee which excludes executive directors, and that pay should be linked to long-term performance measures. Subsequent reports and reviews have gradually produced a Corporate Governance Code which is binding on listed companies. On executive pay the latest iteration of the code (Financial Reporting Council 2014) says that:

> There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration. (Financial Reporting Council 2014: 21)

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but companies should avoid paying more than is necessary. Comparisons with other companies should be used with caution. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. These performance-related elements should be 'stretching and rigorously applied' (ibid: 20). Changes to company law brought in by the coalition require much greater transparency in the reporting of all elements of pay. The Enterprise and Regulatory Reform Act 2013 requires UK-listed companies to publish a 'single figure' for the total pay awarded for the top executive's position.[26] Most companies also provide data going back to 2010 for comparative purposes (they will eventually have to provide such information for the previous ten years). Regulation now also requires that a company's remuneration policy be approved by more than 50 per cent of shareholders.

25 It is claimed that, with dispersed shareholding, it is very difficult for shareholders to exercise control over management, and that this justifies government intervention. This however ignores the way in which large institutional shareholders such as pension funds can exert pressure on management should they choose to do so. It is also worth remembering that the UK has an active market for corporate control, so managers who act against shareholders' interests can face a hostile takeover.

26 A theoretically difficult thing to do, as it involves assessing the value of future income streams and the risk associated with assets.

These changes appear to have had little impact on slowing the growth of pay: top executive salaries have continued to drift up in the UK as they have done in other countries with different systems of corporate governance. Some indicators suggest top executive pay in Germany has overtaken that in the UK, despite it having a system of corporate governance - widely praised by the left in the UK - involving stakeholder representation in a two-tier board system.[27]

More radical proposals have accordingly been developed by the High Pay Centre. They include setting a maximum pay ratio between CEOs and average-paid workers; mandating worker representation on company boards and remuneration committees; and legally-binding targets for reducing pay inequality within firms. Interest has been shown in these ideas by the Labour Party, which has endorsed the idea of employee representation on remuneration committees, while Jeremy Corbyn has also floated support for restrictions on the ratio of CEO pay to that of the lowest paid. Labour has set up an ‘executive pay commission’ to recommend detailed proposals. More recently, the new Prime Minister Theresa May has proposed appointing consumers and employees to boards, binding shareholder votes on pay, publication of pay multiple data and restrictions on bonuses.

The idea of worker representation on boards of directors seems to be regarded as an important factor in regulating CEO pay. Yet evidence from Germany, where this sort of co-determination has existed for many years, suggests that employees often resist restructuring efforts, and this can cost firms about 26 per cent of shareholder value (Gordon and Schmid 2000). And interestingly, binding votes on pay may actually make it less likely shareholders will cast a vote than if the vote is merely advisory.

It needs to be remembered that too much government interference with company structures may make large multinational firms wary of basing themselves in the UK. Many CEOs of UK-listed companies are foreign nationals, over half of the shares in LSE-listed companies are held by overseas investors, while over three-quarters of the revenues of FTSE-

27 See http://www.thecsuite.co.uk/CEO/index.php/people-management/167-ceo-pay-in-germany-and-uk-454354 (accessed 29 June 2016).

100 companies are earned outside the UK.[28] Such multinationals could be listed in other stock markets, or remain unlisted, if restrictions became too irksome.

One area where tighter restrictions have already been implemented is that of bankers' pay. It is widely believed, although probably mistakenly[29], that inappropriate and excessively generous pay structures, especially the use of bonuses, were an important element in the failings of the banking system leading to the crash. Regulators both in the UK and at the European Union level have stepped in with new rules.

In the UK the Prudential Regulation Authority now has the power to recover variable pay elements for up to seven years from the date of the award, which raises all sorts of issues about property rights and reasonable use of government power. Meanwhile the EU restricts bonuses to 100 per cent of bankers' pay, or 200 per cent with shareholder approval – a rule which the UK initially opposed on the grounds that it would lead to increases in the level of fixed pay and thus reduce the element of performance-related remuneration. As so often, restrictions on pay can usually be circumvented in one way or another. Banks have been getting around bonus restrictions by using 'top-up allowances', which the European Banking Authority (EBA) wants to proscribe. The EBA also wants to spread the restrictions to bank subsidiaries in fields such as fund management and insurance.

The public sector and not-for-profits

Critics of pay regulation fear that businesses will be driven to relocate abroad or reduce investment in the UK. This is certainly a real possibility, though there is not much evidence of this happening as yet. But the antipathy towards high pay is having an impact in other areas – in local and national government, and in the not-for-profit sector.

Unease about alleged high pay in the public sector led the coalition government to set up an enquiry under Will Hutton, a long-standing critic

28 See http://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2015-09-02 and http://citywire.co.uk/money/study-reveals-higher-proportion-of-ftse-revenues-derived-overseas/a716388 (accessed 25 July 2016).

29 See the Turner Review (Financial Services Authority 2009), which saw inadequate approaches to capital, accounting and liquidity as more important factors than pay structures.

of high salaries. It was expected to lead to a cap on the ratio of top pay to low pay; a maximum for public sector chief executives of twenty times the pay of the lowest-paid was touted. However his report (Hutton 2011) turned out to be a sensible recognition of the dangers of populist thinking. Hutton pointed out that the extent of high pay in the public sector was greatly exaggerated. He also noted that a ratio-based pay cap could create odd incentives: if it was thought important to raise top pay, a cap could be rendered ineffective either by arbitrarily raising the pay of a handful of low-paid workers – or, more worryingly, by contracting their work out to private businesses. More fundamentally, Hutton argued that 'the UK must take care to avoid making the public sector a fundamentally unattractive place for those with talent and drive' (ibid: 10).

If strict regulations were avoided by Hutton's conclusions, the climate of opinion has made it very difficult to increase public sector pay across the board, and certainly at the top end. This is a good thing in some ways, for instance in helping to rein in the fiscal deficit. However there remains a danger that public sector jobs - many of which are highly challenging, and require top-level candidates with vision and the ability to push change through - may become the preserve of the less ambitious and less competent.

This isn't just the case for the public sector, strictly defined. University vice-chancellors are another group whose pay has come under public scrutiny. Running a major university today is a demanding job, requiring managerial skill, fund-raising ability, and considerable stamina, usually on top of a strong academic record. VCs are also increasingly appointed against international competition. Yet their pay is under regular attack from university trade unions and politicians. A nadir was reached when, just before the 2015 general election, Shadow Minister Liam Byrne threatened vice-chancellors opposed to Labour's policy of reducing university fees to £6000 per year with an enquiry into their pay.[30] A real danger in making top pay a political football is that it will inhibit criticism of politicians.

30 See http://www.timeshighereducation.co.uk/news/academys-fat-cats-too-smart-to-attack-labours-6000-fees-policy/2016354.article (accessed 29 June 2016).

What should the government's pay policy be?

One classical liberal view is that the government should not intervene at all in the determination of pay. As Richard Epstein has written:

> the terms of an employment contract are the business of only the parties to it. Freedom of contract on this matter is no different from freedom of speech or freedom of action (Epstein 1992: 149).

In this view, there should be no government involvement on principle. A more pragmatic position might build on the economist's presumption, sketched at the beginning of this paper, that free determination of contracts, like free trade, normally benefits both parties and leads to an optimal level of output and employment.

Clearly neither of these approaches currently has very wide support. We prefer to argue that the interventions we have examined suggest that much policy is based on poor analysis, and is often badly targeted to deal with the problem which it is intended to tackle. Moreover there are often unintended consequences as businesses react to policies imposed on them.

Support for the National Minimum Wage and the National Living Wage is often based on the assumptions that firms have excessive market power (monopsony) which they use to exploit workers, and that state-determined increases in pay are borne by employers rather than consumers, taxpayers and employees. It is also the case that minimum wages are not a particularly effective way of raising living standards as they do not help the unemployed (whose numbers they help to swell), and often benefit individuals who are not in poverty.

The gender pay gap is widely assumed to be primarily the consequence of employer discrimination, when most of it can be explained by the choices made by individual workers. Policy which attempts to stigmatise particular employers may lead to their taking steps which may actually worsen the position of some women workers. Moreover exclusive focus on this type of pay gap ignores other pay gaps such as those associated with ethnicity – and may indeed exacerbate them.

The focus on top executive compensation assumes that high pay is irrational, that it is the result of cronyism associated with the UK's system of corporate governance and was an important causative factor in the banking crisis. None of these propositions is firmly based. Attempts to control executive pay are unlikely to succeed, but the anti-high-pay culture may cause collateral damage to the public sector and quasi-public sector bodies.

One problem is that there are strong, organised voices – trade unions, the Living Wage Foundation, the Equality and Human Rights Commission, the High Pay Centre and so forth – which advocate more and more intervention. When policies do not achieve the desired result, usually because they are based on mistaken analysis or prejudice, the answer is always to press for further government interference. In the nature of things, it is difficult to organise any opposition to the policies outlined here, which are often seen to be driven by the best of intentions. Governments need to be more wary of single-issue pressure groups.

Some suggestions

Nevertheless, in a democracy we have to recognise that there will always be concern over pay issues. Therefore, it is worth outlining some pragmatic steps that could be taken given the wealth of theoretical and empirical issues in most of these areas. We make the following suggestions:

The minimum wage structure should be simplified

As outlined above, the NMW had broad public support but the introduction of the National Living Wage threatens to lead to a populist arms race in terms of statutory minimum pay rates. We offer the following suggestions to avoid some of the negative consequences outlined earlier:

- Have just two minimum wage rates, for people 18 and over and 25 and over. There does not need to be a minimum wage for young people under 18, who are now required to be either in education or training, and we know that minimum wages in any case tend to affect most adversely the employment of the very young.
- Abandon the planned increases in the NLW from next year onwards, and re-emphasise the independence of the Low Pay Commission, allowing it to continue to recommend changes to both rates in the new system according to the best evidence available on the pay-employment trade-off. This is particularly important given the pressure there will be to continue increasing wage rates even in economic recessions.
- In line with the proposals for a federal UK as outlined in Booth (2016), Scotland should obtain responsibility for setting its own minimum wage legislation as part of its broader economic powers. Gordon Brown briefly considered regionalising the minimum wage further, but this should only take place if and when broader decentralisation of economic powers to local authorities occurs.
- In order to address real concerns about the cost of living and its impact on low pay, the government should adopt the proposal of Niemietz (2012) to devise a prominent measure of poverty which assesses the cost of living of essentials. This should be used to influence government policy on housing, energy, food and childcare.

Raw measures of the gender pay gap should be deemphasised

The raw gender pay gaps we see in the data are not convincing evidence of discrimination. They should not be used as a guide to policy. The government should:

- Abandon the proposed employer league tables. If private sector employers are still to be required to report on their pay gap this should be to their shareholders only and not to any official body.

To the extent that choices may reflect discouragement of women moving into certain professions, schools and colleges should continue their efforts to promote a full range of educational and occupational choices to students.

High pay should be dealt with through the tax system and not through government intervention in business

The issue of top executive pay is much more complex than the populist rhetoric surrounding the subject would imply. There should be no further requirements on firms to publish data on executive pay (such as the ratio of CEO pay to median earnings) or for individual tax returns to be made public.

- The government should not follow through on the proposal to implement worker representation on company boards, a requirement which is likely to create collateral damage.
- Concern over inequality at the top end of the pay distribution is better dealt with by a fundamental simplification of income tax to eliminate exemptions, loopholes and tax shelters. This would have the benefit of also affecting other rich individuals: CEOs of FTSE-100 companies are only a small proportion of top income earners, many of whom (private equity investors and business owners as well as sportspeople, movie actors and musicians) earn considerably more.

It is a regrettable fact that the politicisation of high pay and the increasing threat of political intervention means that companies are increasingly having to take into consideration expectations of a backlash from political activists when formulating pay packages and considering the long-term performance of their business. Our government should discourage this mindset if it wants to maintain this country's reputation, post-Brexit, of being business-friendly.

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